Supreme Court, U.S.
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No. 97-1768

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, and DEAN WITTER REYNOLDS INC.,
*Petitioners,*

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,
*Respondents.*

**On Petition for a Writ Of Certiorari to the United States Court Of Appeals for the Third Circuit**

## REPLY BRIEF FOR PETITIONERS

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## REPLY BRIEF FOR PETITIONERS

Respondents do not dispute our description of what the Third Circuit did. The court of appeals ruled that securities broker-dealers, simply by offering their services, "impliedly represent" that they will take all "reasonably available" steps "to maximize the economic benefit to the client in each transaction" and that if a firm intends to execute small retail orders at the NBBO, but a jury later finds that better prices were "reasonably available," the firm is guilty of *fraud*. Pet. App. 6a-7a, 12a, 15a-16a. Respondents admit that, under the Third Circuit's test, the outcome of this case will depend on whether the jury finds that "better prices * * * were reasonably available" (Opp. 2-8)—a standard that transforms Rule 10b-5 into a guarantor of reasonableness rather than a proscription against fraud.

Respondents do not contest our showing that a broker-dealer's only pertinent implied representation is that it will abide by trade custom and that execution at the NBBO was "almost universa[l]" industry practice, was approved in published guidance from the SEC and NASD, and was "no secret." Pet. App. 15a, 74a. Nor do they dispute our showing that imposition of a duty to "maximize" the economic benefit to customers in principal trades would deprive broker-dealers of the compensation for market-making services expressly allowed by the regulatory scheme applicable to dealers. They make no serious effort to explain how the Third Circuit could hold that a known and nearly universal practice, approved by regulators, could possibly be "fraud," or how that court's application of Rule 10b-5 to patently nonfraudulent conduct can be reconciled with *Hochfelder*, *Santa Fe*, and numerous cases in other circuits.

Respondents also do not answer our showing that this case is of major importance because of its extraordinary magnitude and the burden it imposes on the judiciary. Nor do they deny that the Third Circuit's new approach to Rule 10b-5—impute a representation that the firm will "do its best" and impose *fraud* liability if a jury later decides the firm could have done better—would lead to a proliferation of litigation and vast new liabilities in scores of pending and future cases.

Instead, respondents urge this Court to deny certiorari because this case is supposedly fact-bound, because it arises at the summary judgment stage, and because SEC litigators expressed partial support below for some of their views. None of these contentions survives scrutiny.

1. Petitioners vigorously dispute respondents' factual allegations in this case, including whether, in real life and real time, a firm would better serve customers who place small retail market orders by pausing to search for better-than-NBBO prices. See Opp. 12, 15-17. But these disputed facts make no difference to the outcome of this case because the legal issues are dispositive. There can be no Rule 10b-5 liability on *any* version of the facts respondents say are in dispute.

First, the issue under *Hochfelder* and *Santa Fe* is whether petitioners intended to deceive, not whether a jury later concludes that they acted "reasonably." This is a fraud case, not a negligence case. See Pet. 15-21. Second, it is immaterial that a few brokers may have believed they should go beyond NBBO, because there is *no* dispute "that execution of customer orders at the NBBO was a practice 'widely, if not almost universally followed' in the securities industry during the class period." Pet. App. 15a. Whatever its relevance to claims of breach of fiduciary duty, a difference of opinion among brokers about what is "reasonable" does not make the overwhelming majority viewpoint "fraud." Finally, whether petitioners "intended" to violate a judicially "implied representation" to customers is a question of fiction, not fact. The Third Circuit was not free to invent a representation inconsistent with industry practice and regulatory guidance. The question whether a broker "intended" to act contrary to such a fictitious representation is legally immaterial. See Pet. 22-23.

This is not, in short, a case where any disputed fact makes any difference to the outcome. The legal issues are dispositive and require entry of judgment for petitioners, as the district court and panel recognized.

2. Because the legal issues raised in our petition will not be affected by further factual development, the interlocutory posture

of the case is no barrier to immediate review. See Stern, et al., *Supreme Court Practice* 196 (7th ed. 1993) (a case presenting an "important and clear-cut issue of law that is fundamental to the further conduct of the case and that would otherwise qualify as a basis for certiorari * * * may be reviewed despite its interlocutory status"). Interlocutory review is particularly appropriate in securities fraud cases, especially cases of this extraordinary magnitude that are amenable to termination on summary judgment.

Respondents concede that this Court often grants certiorari to review interlocutory Rule 10b-5 decisions when there is disagreement among the circuits, as there is here. Opp. 16-17 & n.10. But respondents fail to recognize that, as a practical matter, interlocutory review is likely to be this Court's *only* opportunity to clarify important legal principles arising under Rule 10b-5. Because even a Rule 10b-5 "complaint which [is weak] by objective standards * * * has a settlement value * * * out of any proportion to its prospect of success at trial," provided the plaintiffs can survive "dismissal [and] summary judgment" (*Blue Chip Stamps*, 421 U.S. at 740), securities fraud class actions rarely go to trial. In consequence, in order to "fashio[n] substantive law * * * in a manner which makes it easier * * * for a defendant to obtain a summary judgment" disposing of "groundless" Rule 10b-5 suits, this Court has repeatedly granted certiorari to review securities fraud rulings in this same procedural posture. *Id.* at 740, 742-743; Pet. 26-27. See 1 *Bromberg and Lowenfels on Securities Fraud,* p. 2:108, referring to "an avalanche of more than 20 Supreme Court decisions," most rendered at the interlocutory stage: "[t]here can be little doubt about the intensity of the Court's concern over the expansion of securities liability, and its determination to curb."

The burden on the parties and the district court if this litigation were allowed to proceed would be immense. Respondents seek discovery of trillions of dollars in securities transactions in the world's busiest securities market and will be "trying [this] case if it goes back [down] for years." Tr. of Oral Argument at 9 (Oct. 24, 1996). Given its defective legal basis, this massive case should not be permitted to lumber forward.

More important, the Third Circuit's new definition of securities fraud, if left unreviewed, would have serious consequences throughout the securities business, as the three amicus briefs urging this Court to grant certiorari attest. Respondents do not deny that, because executing orders at the NBBO was nearly universal industry practice, the Third Circuit's decision invites suits against virtually every broker-dealer. Nor do respondents identify any limits to the Third Circuit's fraud theory to counter our showing (Pet. 24-25) that it turns every claim that a broker-dealer violated a duty of fair dealing or best execution into a Rule 10b-5 suit and "could not be easily contained." *Santa Fe*, 430 U.S. at 478. By cobbling together a fraud theory out of fictional "representations" and constructive "intent" and making fraud turn on questions of "reasonableness" and "feasibility," the Third Circuit has encouraged a proliferation of new Rule 10b-5 class action suits challenging conduct that, as the court acknowledged, "has never [before] been held to be fraudulent by any court or regulator." Pet. App. 15a.

3. Respondents rely heavily on the SEC's amicus briefs in the Third Circuit. Opp. 9-11, 14-15, 19 n.11. But respondents misdescribe those briefs. The SEC's lawyers told the court of appeals only that they could not "state categorically" that execution at the NBBO "always" satisfies best execution and that the duty of best execution might under some circumstances "be capable of enforcement under the antifraud provisions." See *id.* at 10, 11. But of far greater relevance here, the SEC's counsel confirmed that "the Commission never required that broker-dealers engage in an order-by-order analysis of competing markets during the class period in order to satisfy the duty of best execution" and agreed with petitioners that there were no "alternative systems offering better prices that were reasonably available * * * during the class period." Supp. Br. of the SEC as Amicus Curiae at 6. This alone precludes liability for fraud.

During the class period the SEC published a major report concluding that execution of NASDAQ market orders at the NBBO is "consistent with best execution, absent customer instructions to the contrary." *Market 2000*, 1994 SEC Lexis 136, at *15. The

agency also had previously approved the NASD's mandatory Small Order Execution System, which automatically executed orders at NBBO. See Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042, 44,044 (Nov. 1, 1984); *id.*, No. 34-33377, 58 Fed. Reg. 69,419, 69,420 (Dec. 23, 1993). Shortly after the class period, the SEC reaffirmed that "[i]n the past," executions at the NBBO "were generally recognized as satisfying best execution obligations." Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792, 52,794 (Sept. 29, 1995). These contemporaneous agency pronouncements foreclose any rational inference of scienter or deception. See *Daniel*, 439 U.S. at 566 (the SEC's "past actions," not statements in amicus briefs, are entitled to weight).

4. The Third Circuit relied on the "shingle theory" to impute to a broker-dealer the representation that it would seek every "reasonably available" source of liquidity to "maximize [its customers'] economic benefit." Pet. App. 10a; see Pet. 22. We demonstrated in our petition that dealers have no such duty and that the shingle theory does not imply any such representation. Without exception, court decisions, SEC rulings, and expert commentaries state that a firm, by offering its services, represents only that *it will act in accordance with industry standards and practices*. The shingle theory has never been used to impute a representation that a broker-dealer would act *contrary* to an "almost universa[l]" industry practice. See Pet. 22-23.

Judicial imposition of a duty inconsistent with regulatory guidance and industry practice would deprive the industry of the certainty required to execute millions of transactions swiftly and accurately in volatile securities markets through sophisticated computer and network technology. Respondents only confirm this when they try to distance themselves from the Third Circuit's description of the duty as requiring "reasonable efforts," as determined by a jury, "to maximize the economic benefit to the client in each transaction." Opp. 19 n.11; see Pet. App. 7a, 11a-12a, 13a. Respondents prefer to say that a firm has a duty to obtain the best reasonably available price, but in the real world, as the SEC has always recognized, "best execution" for the customer also depends on "order size, trading characteristics of the security,

speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Supp. Br. of SEC as Amicus Curiae at 5; Pet. App. 9a. If industry practice and regulatory guidance are discarded as guides, it is impossible, as the district court found, to know "what best execution means." Pet. App. 72a.

In an effort to establish a new duty to seek better-than-NBBO prices, respondents relied principally below and in their opposition (at 5-6) on the declaration of former SEC Commissioner Richard Roberts, who opined that a broker may violate its duty of best execution if it executes an order at the NBBO when a "superior price" is "available on Instinet or SelectNet." Addendum A1-A3, ¶ 7. The en banc court expressly relied on that opinion as demonstrating what "respected members of the brokerage community recognized" during the class period. Pet. App. 13a. But Roberts recently informed respondents that he has "reconsider[ed] the opinions" in his declaration, "particularly" the one just quoted, and told respondents they are "not authorized" to use this declaration "in any manner" in "this or any other litigation." Addendum A1-A2. It would be extremely unfair to impute to broker-dealers, long after the fact, a duty during the class period that respondents' own declarant now declines to support. By imposing such a duty on an ad hoc and retroactive basis, the Third Circuit has created tremendous uncertainty in an area where "clarity" and "consistency" are essential. *Musick, Peeler*, 508 U.S. at 295.

5. Under *Hochfelder*, a broker-dealer following virtually universal industry practice that comports with regulatory guidance and is "no secret" to investors cannot as a matter of law be acting with scienter. Pet. 15-16. Respondents' only answer to our showing (Pet. 16-18) that the Fourth, Fifth, Sixth and Eleventh Circuits have all so held is to contend that additional factors in those cases—beyond evidence that the allegedly fraudulent conduct was "a common and accepted industry practice"—suggested a lack of intent or recklessness. *Messer*, 847 F.2d at 678; see Opp. 18-21. But the fact that the defendant followed trade custom was the dominant factor in each decision; there can be no serious question that each of those courts would hold that petitioners here lacked

scienter. See, *e.g.*, *Platsis*, 946 F.2d at 41 ("intent to deceive * * * could not be established" where allegedly fraudulent omission was common industry practice and "there was no established regulatory duty to disclose"). It is telling that respondents, while trying to downplay the conflicts we have identified, cannot cite a single decision that supports the Third Circuit's radical approach to scienter.

The notion that a broker-dealer had the requisite "mental state embracing intent to deceive, manipulate, or defraud" is particularly absurd when a representation is retroactively implied based on a jury's view of what was "reasonable"—so that the broker-dealer's "intent" with regard to that representation is purely constructive. *Hochfelder*, 425 U.S. at 193 n.12; see Opp. 12-13. As the Eleventh Circuit held in *McDonald*, 863 F.2d at 815—a case cited in our petition that respondents fail to mention—a "reasonableness" inquiry "may establish negligence" but it "does not meet the standard for scienter." Former SEC Commissioner Roberts' change of heart about whether broker-dealers should have sought better prices for small orders on Instinet or SelectNet vividly illustrates the dangers of imputing scienter based on jury conjecture about what was reasonable or unreasonable. See *Hochfelder*, 425 U.S. at 190 n.5 (even "inexcusable negligence" does not constitute scienter).

6. Even if there were some merit to respondents' suggestion that better prices were available, an "unreasonable" failure to obtain those prices would at most raise an issue of fiduciary duty. As respondents concede (Opp. 21), under *Santa Fe*, a breach of fiduciary duty, where there is no misrepresentation or lack of necessary disclosure, is not actionable under Rule 10b-5.

Following *Santa Fe*, other circuits have expressly required manipulation or deception. Respondents attempt to explain away the conflicts we identified by claiming that the cited cases did not involve allegations of nondisclosure or misrepresentation. Opp. 21 n.13; see Pet. 20-21. But *Forkin* is closely analogous to this case because it involved allegations that a broker violated an implied "representation of fair dealing." 804 F.2d at 1050. Those allega-

tions raised only issues of breach of fiduciary duty, not fraud; the Eighth Circuit accordingly held Rule 10b-5 inapplicable. A contrary result, the court recognized, would mean that "every instance of broker misconduct would give rise to a cause of action under the anti-fraud provisions of the federal securities laws." *Ibid.* In *Banca Cremi*, the Fourth Circuit likewise refused to countenance a fraud action based on violation of an alleged implied duty to disclose trading practices. 132 F.3d at 1035. The Third Circuit has permitted what these and other circuits forbid: use of an entirely fictitious representation to convert allegations of breach of fiduciary duty into an action for securities fraud.

This Court should grant review to restore the bounds of securities fraud liability established in *Hochfelder* and *Santa Fe* and to prevent the massive burden and industry-wide disruption that will be inflicted by the Third Circuit's faulty legal ruling.

Respectfully submitted.

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June 1998

*Counsel for Petitioners*

# ADDENDUM

**LETTER FROM RICHARD Y. ROBERTS TO RESPONDENTS' COUNSEL DATED MAY 27, 1998**

Richard Y. Roberts
3916 Bentwood Court
Fairfax, Virginia 22301

May 27, 1998

Ms. Karen Morris
Morris and Morris
Suite 1600
1105 North Market Street
Wilmington, Delaware 19801

IN RE MERRILL LYNCH, et al.
SECURITIES LITIGATION
CIVIL ACTION No. 94-534

Dear Ms. Morris:

On January 30, 1998, the United States Third Circuit Court of Appeals reversed a decision of the United States Court for the District of New Jersey granting summary judgment for the defendants in the above-referenced litigation. In the original District Court case, I submitted a Declaration in opposition to the motion for summary judgment by defendants which Declaration was dated October 25, 1995. I hereby notify you in writing that I am not inclined to participate in this litigation in any manner in the future. Further, I hereby notify you in writing that you are not authorized to use in any manner my Declaration dated October 25, 1995, in this or any other litigation. Moreover, I request that you inform the United States Court for the District of New Jersey, as well as opposing counsel in this litigation, of this notification.

A great deal has occurred in the rulemaking and enforcement area by the United States Securities and Exchange Commission, among others, between October 25, 1995, and January 30, 1998, which relates to the subject matter made the focus of the above-referenced litigation. These subsequent events have caused me to reconsider the opinions contained in my Declaration dated October 25, 1995, particularly the one contained in paragraph 7 of that Declaration. Thus, I am not necessarily prepared at the present to express the same opinions set forth in my Declaration dated October 25, 1995.

Sincerely,

/s/ Richard Y. Roberts

**EXCERPT FROM DECLARATION OF RICHARD Y. ROBERTS DATED OCTOBER 25, 1995**

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

| | | |
|---|---|---|
| IN RE MERRILL LYNCH, et al. SECURITIES LITIGATION | ) ) ) | CIVIL ACTION NO. 94-5343 (DRD) |

**DECLARATION OF RICHARD Y. ROBERTS**

| | | |
|---|---|---|
| STATE OF NEW JERSEY | ) | |
| | ) | ss.: |
| COUNTY OF MERCER | ) | |

I, RICHARD Y. ROBERTS, declare under penalty of perjury that the following is true and correct: * * *

7. It would be inconsistent with the duty of best execution for a broker-dealer to advantage itself by automatically executing customer market orders at the NBBO when superior prices are reasonably available. In my opinion, during the Class Period, absent customer instructions to the contrary, a broker-dealer failed to fulfill its duty of best execution to a customer if the broker-dealer did not execute the customer's order at a reasonably available superior price, including such a price available on Instinet or SelectNet (which systems constitute a substantial portion of Nasdaq trading volume), and instead executed the order at the NBBO.